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THE COMPANY AUDIT

Question 1

X Ltd., paid ₹ 25 lakhs as advance to Y Ltd. towards the purchase of printing machinery on 15.1.08 with delivery instructions to deliver the same in the last week of June, 08. Further on 2.2.08 X Ltd. purchased two diesel generator sets from Y Ltd. for ₹ 30 lakhs on 90 days Credit term. In the accounts for 2007-08, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of ₹.5 lakhs as due from them. As the statutory auditor, how would you deal with this?

(5 Marks) (November 2008)

Answer

Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the main heading 'Non-current Assets' with the sub-head as Fixed Assets with a sub-classification as 'Capital Work-in-Progress.' This is as per requirement of Revised Schedule VI to the Companies Act, 1956 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – 'Long Term Loans and Advances' with a sub-classification as 'Capital Advances' under the main heading 'Non-current Assets'. In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will conceal the two material items in the balance sheet – one, expenditure towards capital asset and the other current liability for purchase of the generator set.

Hence, the auditor should advise X Ltd., to show these two items separately. If X Ltd. does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

Question 2

As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit?

(8 Marks) (November 2008)

Answer

The auditor may take the following steps to ensure that the dividend has been paid only out of profits.

1. Check whether the dividend was declared out of profits arrived at after providing for depreciation.
2. If no depreciation has been provided, ensure that the approval was obtained from the Central Government before declaring dividend.
3. Check whether
 - (i) The depreciation was provided according to provision of section 205(2).
 - (ii) The minimum prescribed amount has been transferred to reserves before declaring any dividend.
 - (iii) Conditions governing transfer of higher percentage is complied with.
 - (iv) A board resolution recommending dividend was passed.
 - (v) Dividend was declared (resolution was passed) only in the Annual General Meeting.
 - (vi) Dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order.
 - (vii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.
 - (viii) Permission of Reserve Bank of India has been obtained for payment to non-resident shareholders before the remittance of dividend to their account.
 - (ix) Intimation sent to Stock Exchange in the case of listed company.
 - (x) There were any complaints of nonpayment/delayed payment of dividend and the corrective action taken.

Question 3

What are the duties of a statutory auditor regarding disqualification of a director u/s 274(1)(g) of the Companies Act, 1956 ?
(8 Marks) (June 2009)

Answer

As per section 274(1)(g) of the Companies Act, a director of a public company which,

- (A) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April, 1999 ; or
- (B) has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more is

disqualified to act as the Director. The director in such a case becomes disqualified on the last date for filing the above documents.

The Auditor should therefore obtain representation for :

- (i) names of directors for the period.
- (ii) particulars of appointment/reappointment for above.
- (iii) whether directors have submitted for DD-A as required by the Rules.
- (iv) that the information contained in Register of Directors is updated .
- (v) whether company has committed any default as envisaged above.
- (vi) if default is committed, whether Form DD-B has been submitted.

After ascertaining the above, auditor has to report under section 227(3)(f) whether any director has been disqualified and if so, mention the said fact.

Question 4

What do you understand about Reserved Capital as provided under Section 99 of the Companies Act, 1956? How is it different from Capital Reserve? (4 Marks) (November 2009)

Answer

Reserve Capital

As per Section 99 of the Companies Act, 1956, a limited company may, by a Special Resolution determine a portion of its share capital not being called-up, is to be kept reserved and shall be called-up, in the event and for the purpose of being wound-up.

Capital Reserve

Certain capital profit is transferred to Capital Reserve, which is not a free-reserve. It is not available to distribute as dividend to shareholders. It is generally utilised to write-off capital losses. For example, Profit on re-issue of forfeited shares.

Question 5

- (a) *Mr. Ram, a relative of a Director was appointed as an auditor of the company. Comment.*

(6 Marks)

- (b) *Mr. X, Director of ABC Ltd. made a purchase contract for ₹ 10,00,000 with the company. Comment.*

(5 Marks) (November 2010)

Answer**(a) Appointment of the Auditor**

Section 226 of the Companies Act 1956 deals with the qualification of Company auditors. According to that section there is no bar or prohibition on a relative of a director or partner of such relative to be appointed as auditor. Section 226 of the companies act specifically prohibits a member from auditing the accounts of a company in which he is a director or in the employment of an officer or an employee of the Company.

The provisions of the aforesaid section are not specifically applicable to the member who is relative of a director. According to the code of ethics there is no direct restriction on a member to accept the audit of a company where his relative is director. According to Clause 4 of Part 1 of Second Schedule of Chartered Accountants Act, 1949 there is professional misconduct if the member expresses his opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest. Here also there is no mention of relative. But this clause has been inserted for the purpose of ensuring the independence of the auditor so that his opinion on the financial statements is an independent opinion free of any interest.

In August 2008 the council has issued a guideline in this respect. As per that guideline a member of the institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are relatives within the meaning of section 6 of the Companies Act, 1956, have either by way of themselves or in conjunction with such members, a substantial interest in the said business or enterprise. Therefore if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

Before the amendment of the Chartered Accountants Act in the year 2006 there was no such restriction and the relative was able to express his opinion on the financial statements of the business entity provided he disclosed his interest in his report. The wording "provided he disclosed his interest" have been removed in the Chartered Accountants (Amendment) Act 2006 and the council has come out with the guidelines and the member has to desist from undertaking the audit of financial statement of the enterprise where his relative has substantial Interest. Substantial interest has also been defined by the council as sharing of more than 20% profits of the enterprise or holding shares having more than 20% of the voting power at any time during the relevant year.

In the instant case Mr. Ram, a relative of a Director, should not accept the appointment of auditor of that company.

(b) Responsibility of Auditor in relation to the Companies Act 1956.

As per Paragraph 4(v) (b) of CARO, 2003 the auditor has to comment "whether transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant

time. Further, this information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year."

The contracts or arrangements covered above are those for which the register(s) are maintained under section 301 of the Companies Act, 1956. The scope of the auditor's inquiry under this clause is restricted to such transactions referred to in sections 297 and 299 of the Act.

The auditor should, while reporting on this clause of the Order, in the first instance, determine whether the aggregate value of all the transactions entered into with any of the companies/firms/parties covered in the register maintained under section 301 of the Act exceed the value of rupees five lakhs. If so, the auditor has to examine whether each of the transactions entered into with such a company/firm/party have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Further, the auditor while reporting under this clause above should clearly bring out the reasons as to why no adverse comment was considered necessary.

The contracts referred to in section 297 are for sale, purchase or supply of any goods, materials or services and contract of underwriting the subscription of any shares or debentures of the company between a Company and its director or, its relative, a firm in which the director or relative is a partner, any other partner in such a firm or a private company of which the director is a member or director.. The auditor will have to obtain the list of such parties which are covered by section 297 mentioned above.

Hence, the auditor should ensure that all the above provisions have been complied with.

Question 6

While doing the audit, X, the Statutory Auditor of ABC Ltd. observes that certain loans and advances were made without proper securities, certain debtors and creditors were adjusted inter se, and personal expenses were charged to revenue. Comment.

(6 Marks) (November 2010)

Answer

Audit Report

Section 227 (1A) requires the auditor to make certain specific enquiries during the course of his audit. As a result of enquiries if the auditor is satisfied then there is no further duty to report on these matters. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters specified in section 227 (1A). If he is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It should however be noted that the auditor is required to make only enquiries on the matters specified in the sub-section and is not to investigate into the matters referred to therein.

As per Clause (a) of Section 227 (1A) requires the auditor to inquire: "Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members."

If the auditor finds that the loans and advances have not been properly secured, he may enter an adverse comment in the report but cannot probably doubt the true view of the accounts by reference to this fact so long the loans and advances are properly described and presented in terms of Part I of Schedule VI to the Companies Act. Further the auditor to inquire whether or not the terms on which the loans or advances have been made are prejudicial to the interests of the company or its members. If it is, he should qualify his report.

If debtors and creditors are adjusted inter se this amounts to merely book entries then the auditor, as per clause (b) should enquire "whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company." This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards".

Regarding Personal Expenses Clause (e) of section 227 (1A) requires the auditor to inquire: "Whether personal expenses have been charged to revenue account." The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

In the instant case, Mr. X, the statutory auditor of ABC Ltd., needs to enquire in light of above provisions, as a result of the enquiries if he is satisfied then there is no further duty to report on these matters.

Question 7

Z Ltd. has flexi deposit linked current account with various banks. Cheques are issued from the current account and as per the requirements of funds, the flexi deposits are encashed and transferred to current accounts. As of 31st March, 2011 certain cheques issued to vendors are not presented for payment resulting in the credit balance in the books of the company. The management wants to present the book overdraft under current liabilities and flexi deposits under cash & bank balances. Comment.

(8 Marks) (May 2011)

Answer

Presentation of Book Overdraft as per Revised Schedule VI: The instructions in accordance with which current assets being “cash and cash equivalents” should be made out to Part I of Schedule VI to the Companies Act, 1956 states as follows.

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature).
- (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
- (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- (v) Bank deposits with more than 12 months maturity shall be disclosed separately.

From the facts of the case it is evident that in substance the position is that the composite bank balance including the balance in flexi deposit accounts are positive, even though physical set-off has not been made as on the balance sheet date. Further the bank has got the right to set off of flexi deposits against the cheques issued and hence it would be more informative and useful to the readers of the financial statements to disclose the book credit balance as a set-off from the flexi deposit accounts. The disclosure of the said book credit balance as book overdraft under the head current liabilities as proposed by the management is not correct.

Question 8

X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings Per Share (EPS) in the financial statements. The fact of such non-disclosure was however, mentioned in the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case?
(5 Marks) (June 2009)

Answer

Disclosure of EPS is required for all companies as per AS 20 “Earnings per Share”. AS 20 is also one of the AS notified by the Companies (Accounting Standards) Rules, 2006. If the disclosures required by AS 20 are not made, it is the duty of the auditor to qualify in his report “Whether Accounting Standards under the clause as notified u/s 211(3C) have been followed?” Mere disclosure by company in notes does not absolve him of his duty. Further, the

disclosure requirements of Revised Schedule VI in respect of Basic and Diluted EPS should also need to be adhered to.

The same is however not a qualification to affect the "True & Fair" position of financial results of the company.

Question 9

XYZ Limited received a grant of ₹ 25 lakhs under the Government's Subsidy Scheme, for acquiring an imported machinery for setting up new plant. The entire grant received is credited to Profit and Loss Account.
(5 Marks) (November 2009)

Answer

According to AS 12, "Accounting for Government Grants" where grant is received for the acquisition of a specific fixed asset, the same cannot be credited to Profit and Loss Account since it fails to match revenue with the cost.

As per AS 12, such grants should be presented in the balance sheet showing the grant as a deduction from the gross value of the asset concerned (in arriving at its book value). Alternately, the grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the profit and loss account on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to profit and loss account, the company has treated it as a revenue income which is not in accordance with the requirements of the accounting standard.

Therefore, the statutory auditor would have to qualify appropriately that the income has been overstated to the extent of the amount of grant net of proportionate credit that would have been worked out.

Question 10

Comment on the following:

- (a) *S Ltd. issued Bonds to the tune of Rs. 100 lacs and provided security to the tune of Rs. 80 lacs for the same. It insists that it will disclose the Bonds as "Secured" in the Balance Sheet of the Company.* (5 Marks)
- (b) *F Limited includes in the Schedule of Inventory, those items of Fixed assets which have not been in active use and held for disposal, as inventory item.* (5 Marks) (May 2010)

Answer

- (a) Prima facie, the Bonds issued to the tune of Rs.100 lacs are provided with security to the tune of Rs. 80 lacs i.e. neither fully secured nor unsecured. Guidance Note on the "Terms used in Financial Statements" issued by ICAI, states "Secured Loans" as loan secured wholly or partly against an asset. Hence the Bonds should be classified under

'Secured Loans' for the purpose of disclosure in the Balance Sheet. However the nature of security should be clearly specified.

- (b) AS-10 "Accounting for Fixed Assets", requires that the items of fixed assets that have been retired from active use and are held for disposal be stated at the lower of their net book value and net realizable value and are shown separately in the financial statements. As per AS-2 "Valuation of Inventories", "inventories" are assets "held for sale in the ordinary course of business, in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services.", whereas, the sale of fixed assets cannot be treated as sale arising from the ordinary course of business.

Thus, F Ltd's inclusion of fixed assets not in active use and held for disposal, as inventory item in the schedule of inventory is not in line with the requirements of AS-10 and AS-2. Such fixed assets should be stated at lower of net book value and net realizable value and are shown separately in financial statements.

Question 11

Comment on the following:

- (a) A Co. Ltd. has not included in the Balance Sheet as on 31-03-2010 a sum of `1.50 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiations which were going on during the last 18 months and concluded on 30-04-2010. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2010. The auditor came to know the result of the negotiations on 15-05-2010. (5 Marks)
- (b) B Co. Ltd. is engaged in the business of developing mass scale housing projects including development of small commercial complexes. The flats/commercial spaces are booked by the public and are allotted by way of allotments letter to each allottee. Major construction activities pertaining to buildings are undertaken after allotment is over. After completing the construction, possession of flats/commercial spaces is given to allottees by executing legal document. The CEO of the B Co. Ltd. says that AS 7 is not applicable to the company. (5 Marks)
- (c) In the notes to accounts of C Co. Ltd. as on 31-03-2010 Note no. 11 states that 'Certain machinery items are lying at customs warehouses and company has paid `900 lakhs up to 30-06-2009 as detention charges, out of which a sum of ` 580 lakhs is written back during the year 2009-10 based on settlement with the concerned authorities in respect of a major spares of machinery. For the remaining machinery items negotiations are pending and a provision of ` 44 lakhs is made. As such total amount of ` 364 lakhs paid/provided on account of detention charges have been capitalized and included in the Fixed Assets/Capital work in progress. The management is of the view that these expenses are directly attributable to the acquisition of the related Fixed Asset. (5 Marks)

- (d) *During the course of audit of D Co. Ltd. you as an auditor have observed that Inter Corporate deposit of `50 lakhs has been overdue. The D Co. Ltd. have disclosed this in the notes to accounts note No. 15 in schedule no. 21 stating that `50 lakhs is overdue from XYZ Co. Ltd. and the said company is in the process of liquidation. The management is taking steps to appoint the liquidator. (5 Marks) (November 2010)*

Answer

- (a) This case requires attention to SA 560 "Subsequent Events", AS 4 "Contingencies and Events occurring after the Balance Sheet Date" and AS 29 "Provisions, Contingent liabilities and Contingent Assets".

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. Similarly as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the will occur.

In the instant case, the amount of `1.50 crores is a material amount and it is the result of an event, which has occurred after the Balance Sheet date. The facts have become known to the auditor before the date of issue of the Audit Report and Financial Statements.

The auditor has to perform the procedure to obtain sufficient, appropriate evidence covering the period from the date of the financial statements i.e. 31-3-2010 to the date of Auditors Report ie.31-05-2010. It will be observed that as a result of long pending negotiations a sum of `1.50 cores representing arrears of salaries of the year 2008-09 and 2009-10 have not been included in the financial statements. It is quite clear that the obligation requires provision for outstanding expenses as per AS 4 and AS 29.

As per SA 560 "Subsequent Events", the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

So the auditor should request the management to adjust the sum of `1.50 crores by making provision for expenses. If the management does not accept the request the auditor should qualify the audit report.

- (b) The contention of the CEO of B Co. Ltd. is correct. AS 7 "Construction Contract", should be applied in accounting for construction contracts in the financial statements of contractors.

The activity of the B Co. Ltd. is not that of a contractor. The company is developing projects on its own account as a commercial venture and is in the nature of production activity and not that of a contractor. Therefore AS 7 will not be applicable to B Co. Ltd.

For the purpose of recognition of Revenue and valuation of inventories B Co. Ltd. should follow the principles contained in AS 9 "Revenue recognition" and AS 2 "Valuation of Inventories".

- (c) As per AS 10 "Accounting for Fixed Assets", the cost of an item of fixed asset comprise its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use.

Generally, detention charges represent an abnormal expenditure, as these expenditures are not directly attributable to the cost of asset.

The auditor will qualify the report appropriately in the paragraph before stating that the balance sheet gives true and fair view and the profit and loss account shows true and fair profit of the year ending on 31-3-2010. The qualification will be as follows:

"Attention is invited to Note no. 11 regarding Capitalization of detention charges of ` 364 lakhs during the year and on account of delays in respect of clearing from custom warehouses for certain machinery items". In our opinion the detention charge are not directly attributable to the acquisition of related fixed assets. The said amount of ` 364 lakhs should have been written off in the Profit and Loss account. Had these expenses been so written off the profit for the year would have been lower by ` 364 lakhs and Reserves & Surplus as well as Fixed Assets/Capital WIP would have been lower by ` 364 lakhs."

- (d) As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the instant case, it appears from the note no 15 that the overdue of outstanding inter corporate deposit may not be realisable in full. The company is in the process of liquidation, makes it clear that on the balance sheet date, the amount of deposit is not safe and is not likely to be realised.

Therefore as per AS 4 provision for the loss is required in the accounts. Hence the auditor should qualify the Audit Report.

Question 12

In the course of audit of T Ltd. you observed that export incentives are not accounted on accrual basis. The company's management contended that these would be accounted on

cash basis citing the uncertainty about its receipts as they are not admitted as due by the customs authorities. Comment. (4 Marks) (May 2011)

Answer

Accountability of Export Incentives: The exporters receive certain incentives (monetary or non-monetary) from the Government of India on export of goods. However due to various procedural delays and laws involved which keep changing frequently, there is generally a delay in actual receipt of the export incentives. Further the receipt of the export incentives may not be assured in certain situations due to frequent changes in the policies of the Government. In such cases, it may be reasonable to presume that the receipt of the incentives is uncertain till the time they are actually received.

As per AS 9 "Revenue Recognition", if at the time of raising the claim for incentive, it is unreasonable to expect ultimate collection, revenue recognition should be postponed. Therefore, as per the accounting standard, if there is uncertainty in the receipt of the amounts, then the revenue in respect of such incentives ought not to be recognized in the books of accounts.

Therefore revenue is to be recognized only when there is reasonable certainty in the receipt of the same. Hence contention of management of T Ltd. to record the export incentive on cash basis is correct.

Note : *An Alternative view is possible, since the export incentives are due as and when the exports have been made from India, though customs authorities does not acknowledge them as due. This does not mean that an uncertainty arises about its receipt. If at all customs authorities have an objection it should be at the time of clearance of the goods for export. The only uncertainty is the timing of the receipt of such incentives, but not the incentive itself. Hence T Ltd. has to account the export incentives on Accrual basis.*